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February 28, 2002

The Honorable Richard G. Lugar
Ranking Minority Member
Committee on Agriculture, Nutrition, and Forestry
United States Senate

Subject: Farm Credit Administration: Safety and Soundness Oversight of the Farm Credit System

Dear Senator Lugar:

In addition to other issues you asked us to study,¹ you requested that we consider whether to undertake a comprehensive review of the Farm Credit Administration's (FCA) oversight of the safety and soundness of the Farm Credit System (FCS). To decide whether a comprehensive review is required, we conducted a limited review of FCA's current oversight program. As discussed with your staff, this correspondence summarizes the objectives, scope, methodology, and conclusions of our limited review.

The specific objectives of our limited review were to (1) determine FCA's current safety and soundness policies and processes and (2) review FCA's oversight of selected institutions and their corrective responses to any weaknesses FCA identified. Our scope included analyses of selected examination reports and other oversight materials related to key FCS institutions. These materials included (1) the last three FCA examinations for the three largest FCS banks, which represent about 60 percent of total FCS assets and of the gross loan volume; (2) the last three examinations for the Federal Agricultural Mortgage Corporation; (3) the last two examinations for the Federal Farm Credit Banks Funding Corporation, the FCS fiscal agent; (4) the last three examinations for the Farm Credit Leasing Services Corporation; and (5) the last three examinations of and other materials related to an institution under "special supervision," a category primarily for entities experiencing weaknesses that FCA believes cannot be corrected in the normal course of business.

¹ Other issues included FCA's (1) administrative expenses and assessment process and (2) oversight of FCS mission compliance. We have published a report on the first issue. See *Farm Credit Administration: Analysis of Administrative Expenses and Funding Through Assessments* (GAO-01-949, Aug. 2, 2001). We plan to report to you on FCA's oversight of certain aspects of FCS's mission compliance on March 8, 2002.

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GAO-02-324R FCA Safety and Soundness Oversight

In addressing both objectives, we reviewed and analyzed FCA policies, procedures, and reports relevant to conducting on-site examinations, performing off-site monitoring, and imposing increased supervisory actions related to safety and soundness. We also reviewed relevant GAO work, plus recent reports and other materials from the FCA Office of Inspector General and the Farm Credit System Insurance Corporation (FCSIC). To enhance our understanding of the safety and soundness oversight policies and procedures, we met with FCA officials to discuss questions we had about specific examinations, other reports, and analytical tools used in oversight activities. We also interviewed the Inspector General about the findings of evaluations completed by his office that relate to safety and soundness. Finally, we interviewed FCSIC officials about their ongoing monitoring of FCS safety and soundness and the use of their authority to conduct special examinations.

On the basis of our limited review of FCA's current oversight program, we do not believe that a comprehensive review is warranted at this time. We take this position because our review showed that the various elements of FCA's safety and soundness oversight and supervision appeared to be timely, comprehensive, and effective. For example, FCA's examinations were timely and covered key areas of risk, such as capital adequacy and internal controls. We observed that FCA required FCS institutions to take appropriate and timely corrective actions to address any identified weaknesses and closely monitored the institutions' compliance. We also found that FCA had special supervisory and enforcement procedures in place and used them when it found more serious weaknesses at FCS institutions. In addition, FCA's off-site monitoring efforts included timely analyses of relevant qualitative and quantitative information that allowed FCA to identify, monitor, evaluate, and proactively address risks faced by FCS institutions. Examples of these efforts include analyses of internal and external audit reports and quarterly stress tests of institutions' loan portfolios. Finally, FCA follows processes designed to ensure the quality and reliability of its safety and soundness examination process through periodic quality assurance reviews and the Inspector General's audits and inspection reports. The enclosure outlines the elements of FCA's oversight program that we reviewed and discussed with your staff.

We provided FCA with an opportunity to review and comment on this correspondence. On February 13, 2002, FCA's Executive Assistant to the Chief Operating Officer noted that only oral technical comments on the correspondence would be provided. We have incorporated these comments into the final product as appropriate.

We are sending copies of this correspondence to the Chairman of the Senate Committee on Agriculture, Nutrition, and Forestry; the Chairmen and Ranking Minority Members of the Senate Committee on Banking, Housing, and Urban Affairs, the House Committee on Financial Services, and the House Committee on Agriculture; and Michael M. Reyna, Chairman and Chief Executive Officer of the Farm Credit Administration. The letter will be available on GAO's Internet home page at <http://www.gao.gov>.

If you have any questions, please contact me or Katie Harris at (202) 512-8678. Joe Hunter was a major contributor to this correspondence.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Davi M. D'Agostino". The signature is fluid and cursive, with the first name "Davi" and last name "D'Agostino" clearly legible.

Davi M. D'Agostino
Director, Financial Markets and
Community Investment

Enclosure

Enclosure

Elements of the FCA Oversight Program That Are Subject to GAO's Limited Review

Examinations

- Statutory requirements on the frequency of periodic exams and FCA's policy
- Risk-based examination approach
- Special examinations
- Planning of examination scope: follow-up to prior findings, ratings, monitoring activities, external and internal audits, and reviews
- Examination manual and areas covered by examinations, including capital adequacy, loan underwriting, and internal controls
- Reports of examination
- Prompt corrective action, tracking and evaluating of responses

Increased Supervisory Actions and Oversight

- Special supervision
- Enforcement supervision
- Office of Examination - Special Examination and Supervision Division

Off-site Monitoring Efforts

Proactive efforts to ensure safety and soundness and identify weaknesses early include

- Early Warning System: quarterly call reports; Financial Institution Rating System; quarterly benchmark rating and trends report; semi-annual Stress Analysis Report; quarterly loan portfolio stress model analysis; semi-annual analyses of new money, refinancings, and rollover trends; annual analysis of loan underwriting standards
- monthly analysis and reports to FCA Board on high-profile institutions
- analysis of FCS Contractual Interbank Performance Agreement scores and data and Market Access Agreement reports
- periodic analysis of documents obtained from FCS institutions, such as board minutes, strategic and operational plans, and internal and external audit report

Requirements for compliance and increased supervisory action include

- reporting
- board involvement
- on-site follow-up

Enclosure

Examination Staff

- Professional certification; internal and external training
- Office of Inspector General's annual survey of FCS

Quality Assurance Program

- FCA field office supervisory review and verification of exam results
- Peer review program
- Office of Inspector General

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